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Let's sit down and make a deal
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Given the increasingly strident demands by the United States for China to float the yuan, it may appear that this is the main policy element in addressing America's large and growing current account deficit.

It may also leave the erroneous impression that this single step would address the wider issue of international payments imbalances.

But the undervalued yuan is just one element in the complex interlocking disjuncture, and a rather minor one at that.

A more positive step towards resolution would be to replace the narrowly focused bilateral harangue with a return to old-fashioned international economic diplomacy in the form of policy co-ordination.

The vehicle for such co-operation already exists, in the G20 grouping; it would seem time to use it in this role.

As well as China and the US, the G20 consists of Argentina, France, Japan, South Africa, Australia, Germany, Korea, Turkey, Brazil, India, Mexico, UK, Canada, Indonesia, Russia, Italy, Saudi Arabia and the EU.

If the yuan were the central issue, resolution would be relatively straightforward. The first element here would be to turn down the volume of the debate: the demands of the US Congress that the Chinese do something may be the greatest inhibition on the Chinese, with their understandable historical reluctance to kowtow to foreign demands.

Given a bit of breathing space, the Chinese will probably accept that it's in their own interest to reset the parity.

At a technical level, what should usefully be done is clear enough — an appreciation large enough to convince financial markets that enough has been done. A smaller move will just encourage the capital inflow whose impact on foreign exchange reserves is actually larger than the influence of the current account surplus.

Then, given that floating exchange rates routinely move well beyond the "fundamentals", even in deep, well-developed markets, the rate should be pegged — but this time against a basket of currencies, so that it doesn't, once again, become hostage to US dollar movements.

The freeing up of China's international capital account can wait until its financial sector is more robust.

But appreciating the yuan, in itself, would not go far in resolving the current international imbalances. For every dollar reduction in the US deficit, some other country's position must deteriorate by a dollar — and the Chinese surplus, amounting to less than one-tenth of the US deficit, just isn't big enough to do the job alone.

The big surpluses are in Japan and Germany, which will find the adjustment particularly painful. International adjustments must have their domestic counterpart: for America, the fundamental driver of the imbalance is the budget deficit.

Easy as it is to criticise the budget deficit, it may, fortuitously, have been just what was needed to keep demand in America — and the world — expanding at a healthy rate. Reining in the budget deficit will cut demand, which needs to be offset by an alternative stimulus.

Can a further fall in the dollar, encouraging exports and discouraging imports, do the trick? This might be acceptable from the US viewpoint, but there is a "pass-the-parcel" problem here: adjusting net exports in the overseas surplus countries cuts production there, requiring offsets.

Shifts in exchange rate relativities, and not trivial ones, will be needed. And if overall world demand is deficient (as seems likely), this needs to be countered by lower world interest rates and reinvigorated efforts to enhance productivity and investment incentives — not just in Germany and Japan but in Asia as well. Each element of the adjustment has its own time lags and uncertainties.

Now put this in a political context. US officials continue to genuflect to a strong dollar and budget correction will not come easily to a tax-reducing administration caught in a long and expensive foreign adventure.

None of the foreign countries will be happy to see demand for its exports fall, and all will be uncomfortable to see their exchange rates appreciate. The monetary authorities in both Germany and Japan have shown themselves loath to stimulate demand. The Chinese, for their part, are understandably sensitive about being told what to do with their exchange rate, and would have good reason (based on the Asian financial crisis) to have little faith in the ability of a freely floating exchange rate to find a stable market-clearing equilibrium.

The one-off exchange rate adjustment suggested above makes sense but will be criticised by the doctrinal free-market commentators.

As the dollar falls, countries which have built up large dollar reserves face huge losses — a 20 per cent appreciation of the yuan costs China the equivalent of 10 per cent of gross domestic product. During the transition they need to be persuaded to keep up their dollar holdings in the face of further falls in the value of their foreign exchange reserves.

To bring off this adjustment smoothly seems to need nothing short of a miraculous alignment of the planets. But something rather like it has happened before.

In the mid-1980s the US deficit was close to 4 per cent of GDP (compared with today's 5 to 6 per cent), with the dollar overvalued by about 30 per cent.

The adjustment was far from perfect and some would argue that it led to Japan's 1990s recession. But it did occur: the dollar fell in an orderly way and the imbalances corrected over time.

One element of the mid-1980s experience which is now missing is international policy co-ordination. Then, the Plaza Agreement of 1985 endorsed the slide in the dollar that had already begun, and the Louvre Accord of 1987 aimed to stop the slide becoming a rout.

Of course some will argue that these agreements didn't do much, with the adjustment governed by the "magic of the market".

To be sure, policy co-ordination can't take away all the pain, but it may help. To a degree, the issues are co-ordination problems, with elements of "the prisoner's dilemma" — everyone is reluctant to be the first to move, not knowing what the others' response will be.

None of the Asian countries wants to lose competitiveness, so none wants to allow its exchange rate to move more than those of the others.

Getting together around a table offers the potential to resolve the co-ordination problem by moving in lock-step. It can give individual countries courage to take painful decisions, it lets them put the blame on international pressure, and it helps them keep to the script (and keep up their bravery) during the extended process of adjustment. With thoughtful management, it has the potential to avoid a repeat of the excessive liquidity creation that followed the co-ordination efforts in the 1980s.

In the mid-1980s, this co-ordination was done through the G5, predecessor to the G7 group of industrialised nations.

Clearly G7 isn't the relevant group — for a start, China is excluded. Of course China could be added: but this sort of ad hockery would be short-sighted. Not only does G7's unrepresentative membership exclude China, it also reflects a power balance and economic weighting that has shifted greatly in the past two decades.

What's needed is a larger group that reflects today's realities (but not so large as to be unwieldy), with Europe's representation reduced and Asia's increased, and to give "ownership" of the adjustment process to a wider group. Such a grouping already exists — the G20.

The G20 consists of finance ministers and central bank chiefs whose meetings so far have been private, frank, low-key and substantive. It does not carry the historical baggage of its International Monetary Fund counterpart, which has degenerated into set-piece speeches with all the spontaneity and analytical content of a lip-synced pop tune.

G20 meetings provide an opportunity for a closed-door discussion with China on why it would be in its own interests to engineer an appreciation of the yuan.

It could at the same time provide some assurances that these exchange-rate modifications would not be allowed to get out of hand (and there may be some understanding on foreign exchange reserve holdings). It may identify and encourage the least painful elements of adjustment (such as stronger domestic investment in the East Asian countries which have, since the Asian financial crisis, run current account surpluses).

Such a discussion could provide mutual endorsement for the painful elements, such as addressing the US budget deficit and more structural reform in Europe and Japan, and facilitate deal making ("If you do this, we'll do that"), which helps with the political problem of gaining domestic support.

One of the lessons of the 1980s is that the adjustment takes time and may even seem perverse (the US deficit continued to rise for two years after the exchange rate peak). International policy co-ordination helps authorities stay the course.

Frank discussions would also clarify the issues, that the US spends less time lamenting its bilateral imbalance with China and focuses instead on the relevant magnitude — the overall balance.

Most importantly, such co-ordination would head off the tit-for-tat moves towards protectionism, with the US Congress threatening taxes on China's textile exports and China responding with its own trade-distorting tax initiative.

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